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This issue of Title News is devoted in its entirety to the Internal Revenue Code of 1954 and its revisions pertaining to real estate matters. It is a reprint of an address before the New York State Title Association Convention of 1954 by Mr. H. Gilmer Wells, a partner of a New York Law Firm, Cadwalader, Wickersham & Taft, and a member of the Bar of the State of New York and Kentucky. He has been engaged closely in the tax laws for the past fifteen years and has written numerous articles on legal subjects. A recent article entitled "Where The New Tax Code Touches Banks" appeared in the September issue of *Banking*. He has lectured before the Savings Banks, auditors and comptrollers for them and the National Association of Mutual Saving Banks. He is a member of the tax section of the American Bar Association.

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INTERNAL REVENUE CODE OF 1954 AND REAL ESTATE TRANSACTIONS

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I notice that I'm scheduled to speak on the "Internal Revenue Code of 1954." If we take that literally, we're going to be here for the rest of the week. That's perfectly all right with me because I've been having a wonderful time, but since another convention is moving in, we'd better try to shorten it a little bit. I, therefore, will restrict my remarks to the aspects of the new Code which deal exclusively with real estate transactions. Actually, any provision of the Code can in some circumstances be applicable to the real estate field. There are, however, about a dozen provisions that deal directly and exclusively with real estate.

Apportionment of Real Estate Taxes

I think the one that your probably will run into most frequently is the provision relating to the apportionment of real estate taxes between the buyer and the seller. You may recall that under the old law a purchaser of real property was not entitled to deduct his ratable share of real estate taxes if those taxes had become a lien on the property or the seller was personally liable for them prior to the sale. Now, Section 164(d) of the new Code completely changes that rule. We now have allocation between the buyer and the seller of those taxes. The taxes are to be allocated on a daily basis up to the date preceding the day of sale, that portion being deductible by the seller, the taxes for the period subsequent to the date of the sale being deductible by the purchaser. That is not an optional provision. It must be followed in all cases irrespective of the terms of the contract of sale.

There is a special provision in the statute relating to its application to cash basis taxpayers. Now, you can see the situation may arise where the seller will actually have paid the taxes prior to the closing date. Hence the cash basis taxpayer cannot actually effect payment of those taxes. That is taken care of expressly by the statute, so that the cash basis taxpayer is "deemed" to have paid his full ratable share of these taxes.

There is another point covered also —that where the real estate taxes have been paid by the seller in the year prior to the year of closing. The closing papers in the subsequent year allocate the real estate taxes between the buyer and the seller. To the extent that the seller is thus reimbursed for taxes paid and deducted in his tax return of the prior year, you have a recovery which now is taxable as income in the year of closing to the seller, to the extent that he derived a "tax benefit" from the deduction in the prior year.

Accrual of Real Estate Taxes

The Law has also been amended in regard to the accrual of real property taxes for income tax deduction purposes. This amendment applies only to an accrual basis taxpayer. It has no application to cash basis taxpayers. Under the old law, a real property tax was deemed to accrue for deduction purposes at a definite moment of time; generally the time when personal liability for the tax attached or when it became a lien on the property. The new Code provides for an elective method of accruing these taxes ratably over the period to which they relate. It may result either in a tax savings or a tax loss depending upon the particular real estate tax involved. You can, by electing to accrue, pyramid your deductions in one year, or, by the same token, indefinitely postpone deductions until a future year. Now, for that reason, you should exercise great care before electing to adopt this new accrual method.

To illustrate—assume a real estate tax covering the year of July 1, '53 to June 30, '54 which, under the applicable local law, would accrue, or become a lien, on January 1, 1954. Now, under the general law that twelve month's tax would be deductible in 1954. But, if you elect to accrue under this new provision, you get eighteen months' tax accrual in 1954 by reason of the fact that we take in the accrual for the entire twelve months' of the year July '53 to June 30, '54, plus an additional six months for 1954. That is the pyramid effect. Now, if you change that slightly and put your accrual date back in 1953, say October 1, 1953, then if you elect the accrual method, you will get only six months' deduction in 1954 inasmuch as the tax for the period of July '53 to June '54 already has been deducted in the year 1953; hence, the only available deuction in 1954 is the tax for the six months' period from July '54 to December '54.

In the case of New York City Real Estate Taxes it makes no difference. Either under the general rule or on the new electual accrual basis the result is the same as regards New York City taxes. But for the other local taxes it's well to look into it very closely before computing deductions for real estate taxes under this new elective method. And, as I have said, the election is available only to accrual basis taxpayers.

You may elect to go on this method for '54 without the consent of the Treasury Department but for any year after the first taxable year following the enactment of the new Code, you will have to obtain the consent of the Commissioner of Internal Revenue.

New Depreciation Methods

I believe that of all the provisions in the new Code, whether they apply to real estate or any other transaction, probably the most beneficial and the most helpful are those dealing with depreciation. You may recall that under the old Internal Revenue Code of 1939 we had what on its face appeared to be a very simple provision. It provided that there should be allowed as a deduction a reasonable allowance for depreciation, obsolescence, and wear and tear of property. That's all the provision said. Generally speaking, it was interpreted as allowing the use of the straight line method of depreciation with which we are all familiar. In some exceptional and rather isolated cases, other methods of depreciation were allowed by the Treasury. But, we found that every time a taxpayer attempted to use the declining balance method, or any other scientific method, it invariably resulted in difficulty with the auditing revenue agents.

Four Methods Available

To a large extent such difficulties have been alleviated by Section 167 of the new Code. That statute provides that any one of four methods of computing depreciation shall be "deemed" to yield a reasonable allowance for depreciation, therefore deductible without question, if certain conditions are met. First of all, you must establish to the satisfaction of the Treasury the useful life of the property. Once that is established, and the other conditions, which I will describe, are met, your arguments with the Engineering Section of the Service are just about things of the past.

The four methods to which the statute specifically refers are the customary straight line method, the declining balance method, the sum-of-the-year's-digits method, or any other reasonable method which will not in the first two-thirds of the life of the property, yield an allowance greater than that obtainable under the declining balance method. Now these new methods, with the exception of the straight line method, which is always available, will apply only to property, the construction, reconstruction or erection of which is completed after December 31, 1953, and in that case only to the portion of the cost of that property which is attributable to the construction of erection taking place after 1953. They also apply to property acquired by the taxpayer after 1953 if the **"original"** use of such property originated with the taxpayer after 1953.

These provisions may cause us a little bit of difficulty. You can visualize the situation of an apartment building which is completed in December '53. It is not rented; it's sold by the builder in January '54. Now, the purchaser may come under the new depreciation provisions and elect to accelerate amortization under any one of the methods just discussed by reason of the fact that the original use of the property took place after 1953. But, let's assume the builder of that apartment building rented one or more apartments in it in December, 1953. He then sold it in January. As the Code and Committee Reports now read, such property would be disqualified from treatment under the new accelerated amortization provisions.

Straight Line Method

I'm sure that we're all familiar with the old straight line basis wherein the cost of the property, less salvage value, if any, is amortized equally each year over the life of the property. Your depreciation allowance is determined by dividing your cost, less salvage value, by the useful life of the property. For example; a property having a forty-year life would have a 2½% rate.

Declining Balance Method

On the declining balance method, which is a form of accelerated depreciation where your larger allowances fall in the first years of the property's life, you apply a uniform rate which may not exceed twice the rate used under the straight line method, to the unrecovered basis of your assets so that your rate will apply to a constantly declining base, your base being reduced by annual depreciations; hence the term "declining balance".

One important thing about this declining balance method is that you will find that at the end of the useful life of the property you will have a residue undepreciated which represents salvage value. That may, in some cases, be a deterrent to the use of the declining balance method.

Sum-of-the-Year's-Digits Method

The sum-of-the-year's-digits method is somewhat newer. Here, you apply a constantly changeing fraction to the cost of the property less salvage value. That fraction is obtained in this manner. Let's assume that we have a property having a ten year life. We add up the digits in the life of the property; namely ten, adding one up to ten which gives us fifty-five. That gives us the denominator of the fraction. Our numerator for the first year of depreciation is ten, that being the first depreciable year of the life of the property, starting at the top and working down. So that we would take 10/55 of the cost of the property in the first year, 9/55 in the second, 8/55 in the third and so on. You will find that under the use of this method you will not have any residue remaining at the end of the useful life of the property. To that extent it is more advantageous than the declining balance method. There is, however, one difficulty with it. The statute specifically gives the taxpayer the elective right to change from the declining method back to the straight line method at any time without the consent of the Treasury. That isn't true in the case of the sum-of-the-year's-digits method. Once you elect that, you're stuck with it until such time as you get the consent of the Commissioner to effect a change.

I believe these new depreciation provisions will be exceptionally helpful in that they will undoubtedly encourage the purchase of new, rather than used equipment. They also should encourage the purchase of more expensive equipment than formerly. They should facilitate financing by short-term, as distinguished from long-term, means inasmuch as, a taxpayer can write off a larger initial cost in the earlier years, thereby facilitating the paying off of the loan. Moreover, they undoubtedly will encourage new construction.

One further new provision in regard to depreciation which should be very helpful is that the statute provides that the taxpayer and the Commissioner of Internal Revenue may enter into an agreement as to the useful life of the property and depreciation rate. If that agreement is entered into, it will be followed by the Treasury and must be followed by the taxpayer, until such time as the Treasury on the one hand or the taxpayer on the other, can show changed facts or circumstances which tend to make the agreement no longer equitable from the standpoint of the Government or the taxpayer.

Sale of Personal Residence

The New Code also makes a rather helpful amendment to the provision relating to the non-recognition of gain upon the sale of a personal residence in those cases where the proceeds derived from the sale of a personal residence is reinvested by the taxpayer in a new home within one year prior to the sale or one year subsequent thereto. You may recall that under the old law we determined the actual gain by taking the amount "realized" upon the sale and comparing it to the tax cost or basis of the property. We still do. However, if the proceeds of that sale were reinvested in a new residence by the taxpayer within the prescribed period, it became necessary to determine how much of that gain was "recognized" and how much "non-recognized". In so doing it was provided that to the extent of the excess of the "selling price" of the old home over the purchase price of the new, the gain would be recognized. For example, a ten thousand dollar home sold for twenty thousand, a ten thousand dollar "realized" gain—twenty thousand dollars reinvested in a new home—no portion of the gain "recognized". Eighteen thousand reinvested in a new home, two thousand dollars "recognized."

Deductable Commissions

However, under the old law difficulty was encountered in applying the recognition provision in connection with selling commissions and sale expenses. Selling commissions were generally taken into account in determining the actual amount of "realized" gain on the sale. For example, a ten thousand dollar home, sold for twenty thousand with one thousand sale commissions resulted in a nine thousand dollar "realized" gain. The commissions reduced the sales proceeds. However, in that same case, if one invested in the new home, only the net nineteen thousand dollars proceeds, one thousand dollars of gain was "recognized". The reason being that the old statute compared the "selling price" of the old home with the cost of the new and in defining "selling price" of the old home no adjustments for sales commissions were made. This applied only to the "non-recognition" and "recognition" of gain provisions applicable in the case of reinvestments, and not to the determination of the "realized" gain upon the sale.

The new provision changes this rule and provides that both for the purposes of determining the "realized" gain and for the purposes of determining the "recognized" gain, selling commissions are deductible so that if you have a thousand dollars sales commission on a twenty thousand dollar sale of a home having a basis of 10,000 and the **net** proceeds, as nineteen thousand dollars are reinvested in a new home, no gain or loss is "recognized".

"Fixing Up Expenses"

The statute goes still further in regard to what may be termed "fixing up expenses." Under the old law if an individual desiring to sell his home expended several thousand dollars in minor repair work of a nature that could not be taken into account as a part of the basis of the home sold, such expenses were ignored in determining either the "realized" or the "recognized" gain upon the sale. The new statute retains the old rule in this regard insofar as the determination of the "realized" gain is concerned. By that, I mean that if a ten thousand dollar home is sold for twenty thousand and two thousand dollars of "fixing up expenses" are incurred prior to the sale the "realized" gain is still ten thousand dollars if no reinvestment in a new home is made.

However, now if you go out and effect a reinvestment in a new home of the eighteen thousand dollars which is your net from the twenty thousand dollar sale after the two thousand "fixing up" expenses; under the new law, no portion of the gain is "recognized". In other words, "fixing up expenses" are now taken into account in determining the recognized gain upon reinvestment.

There are several limitations, however. The "fixing up expenses" must have been incurred in connection with work which was done within 90 days prior to the contract of sale. That's the **contract** of sale; **not** the closing. So that if you start incurring expenses fixing up a home preparing to sell it, be sure that you're going to sign a contract of sale within 90 days, otherwise, no benefit is derived from such expenses. Moreover payment for the work must be made within 30 days after the date of the actual sale.

This new rule applies to the sale of any residence taking place after 1953 even though the "fixing up expenses" may have been incurred in 1953, so long as they were incurred within the 90 day period prior to the contract to sale. Accordingly, some November and December 1953 expenses conceivably could be covered.

Reinvestment in Cooperative

The statute has also been broadened somewhat in that under the old law while a reinvestment of the proceeds from the sale of a personal residence could be made in the stock of a cooperative apartment, reinvestment in stocks of a cooperative housing development was not permitted. Under the new Code reinvestment in the stock of a cooperative housing development will not result in non-recognition of gain if the possession of that stock entitles the taxpayer to the occupancy of the dwelling.

Sale of Subdivided Land

The next new amendment which may be of interest relates to the Capital gains or limited capital gains treatment of proceeds from the sale of sub-divided real property. This is a provision that many tax attorneys refer to as a "lawyer's dream". In my view it's a classic case of unnecessary Congressional complication of the law. Under the old law a great deal of difficulty was experienced by taxpayers who, having a large tract of land, sub-divided it for the purposes of sale. By and large the activity in connection with the sub-division and subsequent sale of the lots was viewed by the Treasury as constituting the taxpayer a "dealer" in real estate so that the Treasury took the position in such cases that the land was held primarily for sale to customers in the ordinary course of trade or business, and hence could not qualify as a "capital asset". The result was that the gain from the sale of such property was treated as ordinary income as distinguished from capital gain. In many cases that worked a hardship and Congress in the new Code attempted to do something about it. I don't think they went quite far enough and I also think that too many restrictions are contained in the new statute.

The new law in this regard provides that the sale of sub-divided realty will not, in and of itself, give rise to capital gain if the transaction meets several stipulated conditions.

In the first place, the property must be a "single tract" or parcel. While its size makes no difference whatsoever, it must be a continuous tract. Secondly, it must not have in the past been held for the taxpayer primarily for the sale to customers in the ordinary course of business. Thirdly, it must have been held for a period of five years or more unless it was acquired by inheritance or devise. If the property is acquired by inheritance or devise the five year holding period is inapplicable.

"Substantial Improvement"

The fourth prerequisite is that there must not have been made any "substantial improvement" upon the property by the taxpayer, which substantially increases the value of any lot or plot in the sub-division. That poses a difficult question as to what constitutes a "substantial improvement". Congress very conveniently failed to answer that question. The Committee Reports indicate that the erection of a shopping center would be a substantial improvement which would disqualify from the operation of this section any parcel benefited by the erection of such center. The Committee Reports do say, however, that you may put in minimum all-weather access roads and that where climatic conditions so dictate they may be gravel roads. The Reports nevertheless specifically exclude a hard surface road. That is about as far as the Reports go. I imagine that in the next few years, we are going to see quite a lot of controversy concerning this "substantial improvement" concept.

Where the property has been held by the taxpayer for 10 years, rather than 5, the substantial improvement concept is modified. In such a case you are allowed to make water and sewerage installations, construct hard surface roads so long as it can be shown that the property would not be marketable at the prevailing market prices without such improvements.

Now, let's assume that we have met all these conditions. It would seem that then the sale of the subdivided lots would give rise to capital gain. That, however, would be too simple for our "simplified" tax Code. Actually, only the gain of the sale of the first **five** lots is taxed as capital gain. With the sale of the sixth one in the sub-division, you have a different situation. In that case, 5% of the selling price, not the gain, is taxed as ordinary income to the extent it does not exceed the gain realized. The remainder of the gain is taxed as capital gain. Of course, if five percent of the selling price exceeds the gain, it's taxed only to the extent of the gain. So, that if property were sold for ten thousand dollars and two thousand dollars gain was derived from the transaction, five hundred dollars of the gain would be taxed as ordinary income and the remainder as capital gain. You do get one break, however, the statute specifically provides that any selling expenses shall be allocated first against the portion of gain that is taxed as ordinary income and the remaining selling expenses allocated to the capital gain portion.

Prepaid Income

The new Code also contains an Amendment relating to the taxation of prepaid income. Under the old law a taxpayer who received payments in advance, for example, an advance payment of rent was required to consider such payment as income in the year of receipt, even though a portion of such prepayment might relate to a period falling several years in the future.

The new law now provides an elective tax treatment for prepaid income, applicable only to accrual basis taxpayers. It has no application to a taxpayer who maintains his books on a cash basis of accounting. Under this elective treatment, one may defer the taxability of prepaid income until the years to which the income relates. It may not, however, be deferred for a period in excess of five years following the year of the receipt of the prepayment.

Let's assume a situation where a lessee pays the sixth year's rent in advance. Under this new provision an accrual basis lessor may elect to defer the taxation of that sixth

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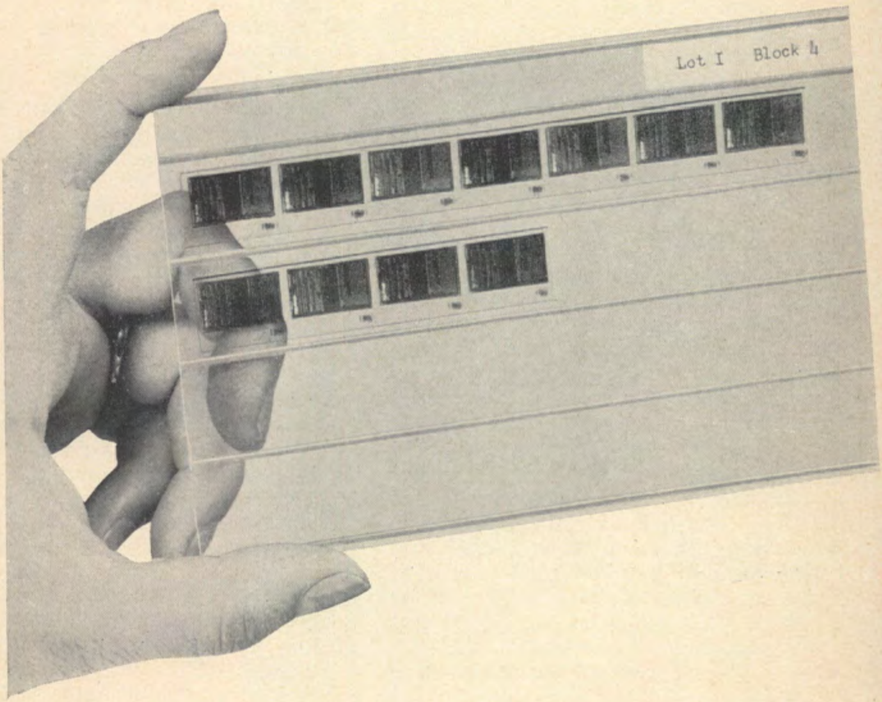

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year's rent until the sixth year of the lease. He is not, however, entitled to spread such payment ratably over the term of the lease. It must be included in the income of the year to which it normally relates or is attributable. Now, in the same example let's assume that the 10th year's rent was paid in advance in the first year of the lease. We have the limitation that we can't defer the income beyond the fifth year subsequent to the date of receipt. Accordingly, in such a case it is necessary to spread the prepayment ratably over the first six years of the lease.

In the event of the death of the taxpayer or the termination of a corporate taxpayer during this deferral period, the entire remaining untaxed prepaid income is taxed in the year of death or the year of termination. If one elects to use this optional method in regard to the taxation of prepaid income, such election applies to all of the prepaid income of the taxpayer's business. You can't for example, if you have two apartment buildings, treat the prepayments of rents on apartment building A under this elective section, and the prepayments of rents on apartment building B under the old general rule. It is necessary to defer all prepayments or to tax them all in the year of receipt.

The election to defer prepaid income is available without the consent of the Treasury in the first taxable year following the enactment of the new Code; the consent of the Treasury to so elect is necessary at any time thereafter.

Installment Sale Provisions

The new Code also contains an amendment in regard to the installment sale provisions. You may recall that in the case of an installment sale of real property made by a non-dealer where the initial payment did not exceed 30 percent of the selling price, it was possible to report the gain ratably over the period of the installment payments. That rule has been retained. However, it has been broadened to some extent. Under the old law the requirement that the initial payments not be in excess of 30 percent of the selling price, was interpreted as meaning that there must be at least some initial payment in the year of sale. That no longer is true. The new Statute, Section 453, provides that there need not be in the year of sale any payment whatsoever in order to qualify the transaction as an installment sale. So one may close in December receiving no payment whatsoever and in January could receive 60% of the total selling price. The case still would come under the installment sale provisions.

Special Assessments

Another amendment relates to the deductability of taxes assessed against local benefits. We know that under the old law such taxes were not deductible. In certain special situations the new law, however, provides that they shall be deductible. In the case of an assessment for local benefits which is levied by a "special taxing district" those taxes may be deducted if, (1) the taxing district covers at least the whole of one county; (2) at least one thousand individuals are subject to the taxes levied by the district; and (3), the district levies assessments annually at a uniform rate on the same assessed value of real property including improvements, as it is used for the purpose of the real property tax generally. As you can see this provision is very limited and will apply only in very special situations. We visualize it as being particularly applicable in the Northwest, where there are quite a few public power districts which levy such special assessments for local benefits.

Tax Basis for Surviving Tenant

With regard to the basis of property acquired from a decedent (when I speak of the "basis", I mean the tax cost which is used in determining gain or loss upon subsequent sale or disposition of property) we have some very substantial and very beneficial amendments in the new Code. Under the old law, the surviving tenant of a joint tenancy, or a tenancy by the entirety, did not get a "stepped-up" basis for the property upon the death of the other joint-tenant. He was required to take original cost for the interest so received. The same was true in the case of property which had been transferred in contemplation of death. For example, A transfers Black Acre to B and subsequently it is held to be a transfer in contemplation of death and includable in A's gross estate. B, under the old law, still would have to take a donor's basis for the property even though the value thereof included in A's gross estate for estate tax purposes might have been twice such amount. That has been changed. The new law now provides that in such cases the surviving tenant will take as his or her tax basis the fair market value as of the date of death of the decedent from whom the property was acquired, or the fair market value as of the optional valuation date for estate tax purposes if such optional date is adopted by the decedent's executor. This new provision applies in the case of any decedent dying after December 31, 1953, irrespective of when the tenancy was first established.

Gift Tax—and Tenancies

In regard to joint tenancies and tenancies by the entirety, another amendment has been effected with regard to gift taxes. It comes as a surprise to many people to realize that under the former law the creation of a joint tenancy or a tenancy by the entirety often gave rise to a Federal gift tax liability. The husband purchases a home, using his own funds, takes title and in the names of himself and his wife as tenants by the entirety. Under the old law, the husband was deemed to have made a gift to the wife, subject to Federal gift taxes to the extent not covered by the applicable exemption or exclusions. Relief from that situation is afforded by Section 2515 of the new Code. That statute provides that the taxpayer, at his election, may treat the creation of such tenancies as not giving rise to Federal gift tax liability. (Incidentally, it is difficult to imagine why one would wish to elect otherwise.) If that treatment is adopted, however, a gift tax will result upon the termination of the tenancy if such termination occurs for reasons other than death. The taxable gift upon termination is measured in this manner. There is a gift to the extent that the proceeds received by one spouse are in excess of the proceeds allocable to the consideration originally furnished by such spouse. Let's assume that a husband and wife purchase a $40,000 piece of property. The wife puts in $10,000, the husband $30,000, and title is taken jointly. Accordingly, the husband pays ¾ of the consideration and the wife ¼. Subsequently the property is sold for $60,000. The husband takes $35,000 and the wife $25,000. The wife originally furnished ¼ of the consideration, so her allocable share of the proceeds from the sale of that property would be $15,000 (i.e. ¼ of $60,000), but she received $25,000. There is, therefore, a gift of $10,000, which is taxable to the extent it exceeds the exclusion and available exemption. Incidentally, this new provision does not apply to tenancies in common. It applies only to joint tenancies and tenancies by the entirety. Moreover, it's applicable only in the case of gifts made after December 31, 1954, since the new gift tax provisions do not become operative until January 1, 1955.

Options to Buy and Sell

Further changes have been made with regard to the tax treatment of options to buy and sell property. Formerly, the gain or loss realized from the failure to exercise an option was treated as a short-term capital loss to the holder of the option and a short-term capital gain to the grantor of the option. Gain or loss resulting from the sale of an option was treated as long or short-term capital gain or loss depending upon how long the option had been held.

Section 1234 of the new Code completely revises the tax treatment of the proceeds from the sale and purchase of options. Gain or loss upon the sale of an option is now treated either as "ordinary" gain or loss or "capital" gain or loss, depending upon whether the property to which the option relates is, or would be, a capital asset in the hands of the individual holding the option. For example, A has an option to purchase an industrial building. He sells the option. The gain, if any, upon the sale is taxed as ordinary income. Why? The industrial building had it been owned by A would not have been a capital asset in A's hands since it represents business real property. On the other hand, assume A has an option to buy a personal residence. He sells the option at a profit. The profit is taxed as a capital gain since the residence would have been a capital asset in A's hands. Under the new law, the gain to the grantor of the option resulting from the failure of the holder of the option to exercise it, in all cases is taxed as ordinary income rather than capital gain.

Double Tax Liability

A further amendment has been made which may be of some interest to a few of you. It relates to the old "Court Holding Company" doctrine. You may recall in the case of closely held corporations, including real estate corporations, some difficulty was encountered in effecting sales of the properties held by these corporations by reason of the fact that a double tax liability might be incurred. For example, real estate company sells its property at a profit and thereby incurs capital gains tax liability on such profit. It then liquidates and distributes the proceeds to the shareholders resulting often in another capital gain to the shareholders. In the Court Holding Company case, the real estate corporation had conducted negotiations with the prospective purchaser of the property. Prior to the actual sale it became aware of the potential double tax situation. The corporation liquidated and distributed its assets to the stockholders who, in turn, transferred such assets to trustees for the stockholders. The sale then was consummated by the trustee representing the liquidating stockholders. A tax was assessed against the corporation and contested. The litigation was carried all the way up to the Supreme Court. The Supreme Court reasoned that in substance that sale had been effected by the corporation rather than by the stockholders, and accordinly capital gain was realized by the corporation. On the liquidation another capital gain liability was attributable to the stockholders. Several years later, the Supreme Court decided a similar case, — that involving the Cumberland Public Service Company. The facts in this latter case were substantially the same with the exception of a very important point; namely—that the sale negotiations were not carried on with the prospective purchaser by the officers or directors of the selling corporation acting on behalf of that corporation. The stockholders there got together and appointed several directors to act for them in their individual capacity as stockholders to negotiate with the purchaser for the purchase of the company's real estate assets. When that deal was buttoned up, the corporation liquidated, the stockholders took title to the property by way of a liquidating distribution and immediately thereafter transferred it to the purchaser. The Supreme Court held that in that case there was only one tax since there had been a **bona fide** liquidation. After that decision the tax results from such transactions were dependent upon the form in which they were cast. Taxpayers with good legal advisors paying one tax—those without—two.

Now Only One Tax

To eliminate that situation the new Code provides (Section 337) that generally speaking, it makes no difference how the sale is effected, i.e., whether the corporation sells its assets and then liquidates, or whether it liquidates first and the stockholders sell. In either event, you now have only one tax. I, therefore, don't think you're going to be troubled to a great extent with the difficulty that you have experienced in the past with stockholders of closely held corporations hesitating to sell because of this heretofore potenial double tax.

There is one point, however, which must be watched. Before the sale of the assets you have the company adopt a "plan of Liquidation" approved by its directors and stockholders. That must occur before the actual transfer of the assets to the purchaser. It's all right to have the contract of sale executed first, but the order must be, (1) contract of sale, (2) plan of liquidation, (3) sale and (4) actual liquidation. The liquidation, incidentally, must take place within 12 months following the actual sale so that one must be sure to avoid any delay in liquidating the company following the sale. Otherwise, double taxation might result.

It may be appropriate to comment briefly on the provision relating to the so-called FHA "windfalls". They attempted in this new Code to plug "loopholes". As you know, some of these FHA builders have recently realized substantial gains through the distribution of excess loan proceeds. They have maintained that these profits are taxable only as capital gains. An attempt has been made to rectify this. Congress rather backed into this problem by approaching it from the concept of the earnings and profits of the distributing company. It has been provided that where a corporation has assets covered by a loan which is insured by the United States, or any instrumentality thereof, such corporation's earnings and profits are to be increased by the amount of any excess of that loan over the cost of the property. The crux of that is this: a distribution by a corporation may not be taxed as a "dividend" to a stockholder unless it is paid from current earnings and profits or earnings and profits accumulated since Feb. 28, 1913. Hence, by including the "excess loan amount" in earnings and profits, the way is paved to tax the distribution thereof as a "dividend" rather than as capital gain. That is what Congress attempted to do. We're still however, left with the question of whether the distribution of the excess amount is a true dividend when it is distributed even though it is distributed from earnings and profits. It still could be in the nature of a liquidating distribution taxable as capital gain. It can also be a distribution (which is covered by a particular provision) which is "essentially equivalent to the distribution of a taxable dividend". It is not as yet clear what the ultimate answer will be. As a matter of fact, some attorneys feel there might even be some constitutional questions on this point.

If any of you have any questions I'll be glad to answer them. First, I would like to say, however, that I am deeply appreciative of the Association's having asked me to address you this morning, and I am doubly grateful for the many new and gracious friends that I've made during my stay at this convention. Thank you all very much.

QUESTIONS AND ANSWERS

Mr. Milton Friedman (New York City): I wonder if Gil would expand one point and give these gentlemen the same benefits that he gave me in a little private tutoring session on the train. I refer to a case in which the buyers and sellers stipulate to adjourn the date of closing of title and in connection with that stipulation it is stipulated that the closing adjustments should be on a day other than that of the closing of title, or, where there's a judgment of a specific performance the decree specifies that the closing adjustments should be on a different day. I understand that under the new tax laws there is a special wrinkle in such a case.

Mr. Wells: The new law doesn't specifically cover that situation . . . It does provide that the taxes to be allocated are the current taxes for the year of the sale. Now in the question you've put we have the problem of when the "sale" takes place. I feel that unless you have some very special judicial order in the nature of a **nunc pro tunc** order, which resulted in retroactively changing the sale date, the purchaser would still be liable for all taxes assumed under the closing adjustments but could not deduct those taxes for the years preceding the year of sale.

In other words the only taxes apportionable for income tax purposes are those for the year of sale.

That brings up another point which I should have mentioned. This allocation of real estate taxes as between buyer and seller does not apply to delinquent real estate taxes. If there are some delinquent real estate taxes on the property, the purchaser, even though he assumes them under the contract of sale, may not deduct those delinquent taxes for income tax purposes. They would, of course, go to increase his tax cost or basis of the property.

Mr. Herman Berniker (New York City): Mr. Wells, you mentioned the situation involving prepaid rent and why don't cash basis taxpayers allocate those over a number of years, or is the provision specifically for accrual basis taxpayers?

Mr. Wells: That's just the reason, the new statute does not apply to cash basis taxpayers. It's applicable only to accrual basis taxpayers.

Mr. William H. Deatly (New York City): Mr. Wells, is a purchaser of existing construction or used equipment bound by the seller's basis of depreciation under the election, as to the methods?

Mr. Wells: Do you mean property which already has been covered by these new 1954 laws?

Mr. Deatly: Yes.

Mr. Wells: You get a new basis just as you did under the old law, unless you acquired the property in a tax free exchange or in some manner that results in a carry-over basis. If you go out and purchase property which has been the subject of accelerated amortization, you still pick up a new basis or tax cost at that time. If the property qualified for treatment under the new depreciation section, that is, constructed after '53 or was originally used after 1953, you could then use one of the accelerated methods of depreciation. The seller's depreciation methods have no bearing generally on the purchaser's tax basis for the property.

Mr. Deatly: And you also might use a different method than he used.

Mr. Wells: Correct, yes. But that would not be true regarding basis if, as I say, you had one corporation obtaining property as a result of a merger with another corporation. But in the average, let's say cash sale, you'd get the new basis. As to depreciation method it would be necessary to ascertain whether the property originally would have fallen right under this section.

Voice: Suppose you have a collapsible Corporation, is it not covered by this Section 337?

Mr. Wells: Well, if you have a true Collapsible Corporation case, it is specifically excluded from Section 337 treatment, which is the so-called Court Holding Company provision. So you'd always have to look at the Collapsible Corporation provisions. I didn't intend to cover that here this morning. But it's true that you have to be sure you don't have a collapsible corporation before you come under this new section.

Mr. Vincent Wiser (Rochester): Is there any chance if you do not come within the provisions that there is less tendency to adopt it or transfer it?

Mr. Wells: Yes, I think it would be. If for one reason or another you could not come within the provisions of this new statute Section 337, which incidentally is highly particularized in that you must meet its specified conditions, the result would be that the selling corporation probably would have a tax liability. Now if that tax liability is in addition to one on the stockholders on a liquidation you would have a problem.

Mr. Wiser: And yet we have no control over that.

Mr. Wells: You'd have a question as to the extent of your liability. I think it would bear investigation. If there is no question about the corporation's liability it would flow out to the stockholders.

Mr. Wiser: Other than that I'm thinking of the transferee liability following the property.

Mr. Wells: I would be inclined to doubt that if you had a **bona fide** purchaser from the corporation that a tax liability stemming from the sale would follow that property. Your liability would go more definitely to your stockholders rather than your purchaser of the land.

President Kersten: Any further questions?

Mr. Lawrence Ott (Schenectady): One question, what would be the treatment for the seller occupying part of the property and then sold the property and then occupied it as a one-family home. Previously he had tenants in there or else used part of the property as a law or a doctor's quarters?

Mr. Wells: You're speaking now of non-recognition of gain on the sale of personal residence.

Mr. Ott: Yes.

Mr. Wells: Well, the only requirement is that the residence sold be the principal residence of the taxpayer, and that the residence purchased be the principal residence of the taxpayer. Now, I don't believe that there is any absolute restriction if, for example, you have a tenant in the premises sold. In such case an allocation of gain would be required. It does not, of course, apply to an apartment or anything like that.

Index of Topics Covered